Indian Taxpayers *May be Taxed* under Liberal Language of Tax Treaties

Sometimes, situations of jurisdictional double taxation arise due to the domestic tax laws, e.g. provisions of the Income-tax Act, 1961 that follow *residence* rule of taxation, are so comprehensive that they levy tax on the global income of resident taxpayers, irrespective of the source or place of income. While a mechanism to reduce or eliminate this jurisdictional double taxation has been devised under our domestic tax laws by empowering the Government of India to enter into the double taxation avoidance agreements or treaties with the governments of other countries, there has been an ongoing dispute over the issue between taxpayers and tax authorities in India. Read on to know and understand the tricky situation…


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Provisions of the Income-tax Act, 1961 that follow *residence* rule of taxation, are so comprehensive that they levy tax on the global income of resident taxpayers, i.e. income of a resident Indian from whatever source, wherever earned and wherever received, comes under the gamut of domestic tax laws. Such a wide amplitude of domestic tax laws, sometimes gives rise to the situation of jurisdictional double taxation. To understand jurisdictional double taxation, consider a resident Indian who earns income in Singapore and both Singapore and India impose tax on that income—India, because the person is its resident, and Singapore, because the income is sourced there. This is a simple case of jurisdictional double taxation.

While a mechanism has been devised under the Indian domestic tax laws to reduce or eliminate jurisdictional double taxation, by empowering the Government of India to enter into the double taxation avoidance agreements (DTAA or tax treaty) with the Government of other countries, whether the foreign sourced income of an Indian resident should be liable to tax in India or not has been a matter of dispute between taxpayers and the tax authorities.

Section 90(2) of the Act apparently provides that in relation to a taxpayer to whom the tax treaty applies, the provision of Indian domestic tax laws shall apply only to the extent they are more beneficial to the taxpayer. This principle has been affirmed by courts as well, including the Supreme Court. Moreover, it is made clear in the recent pronouncements by the various courts that the option available to the taxpayer to make a choice to be taxed under either the domestic tax laws or the relevant DTAA is not one time exercise. It is not that once the taxpayer has decided to be governed by the provision of the domestic tax laws or of the relevant DTAA in a particular tax year, he cannot choose otherwise in the subsequent years.

If the tax laws of India are so clear to give overriding power to the tax treaties, why are there frequent disputes between taxpayers and authorities on whether a particular foreign income of an Indian resident is taxable in India? One of the reasons contributing to this ever going dispute is the language of the tax treaties, which liberally uses the phrase *may be taxed* to define the taxing rights of a contracting state.

Various Indian courts interpret this *may be taxed* phrase differently that is used in tax treaties.

OECD and UN Model Tax Conventions and Commentaries

India has entered into more than eighty tax treaties with different countries and most of them are based on the OECD Model Tax Convention. OECD Model often uses the language *may be taxed,* while describing the taxing rights of the two jurisdictions.

For example, Article 7 on taxability of business profits states that the profits of an enterprise of a contracting State *shall be taxable* only in that State, unless the enterprise carries on business in the other contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, i.e. through a permanent establishment situated in other contracting State, the profits of that enterprise ***may be taxed*** in the other State, but only so much of them as are attributable to that permanent establishment.

Similarly, all other articles of the OECD Model Tax Convention uses the language *may be taxed* or *may also be taxed*, except Articles 8 (Shipping income), 12 (Royalties), 18 (Pensions), 19 (Government services), 20 (Students) and 21 (Other income), which uses the language ***shall*** *be taxed*. Clause 13 of Paragraph 1 of the 2010 release of the OECD Commentary on Model Tax Convention explains that the purpose of paragraph 1 of Article 7[1] (Business profits) is to limit the rights of one contracting State to tax the business profits of enterprises of the other contracting State.

OECD commentary on Article 7 states that paragraph 1 of Article 7 restates the generally accepted principle of the double taxation conventions, that an enterprise of one State shall not be taxed in the other State, unless it carries on business in that other State through a permanent establishment situated therein. It is perhaps sufficient to say that it has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within other State's taxing rights.

Another principle, which is reflected in the second sentence of this paragraph, is that the taxing right of the State where the permanent establishment is situated, does not extend to profits that the enterprise may derive from that State, but only those which are attributable to the permanent establishment.

The commentary on United Nations (UN) Model Tax Convention also put reliance on the OECD commentary for the explanation of paragraph 1 of Article 7[2] (Business profits). However, it has extended the scope of taxation for the source country, i.e. the country where permanent establishment was established by applying force of attraction rule.

Similarly, in the case of other items of income, for instance dividend, the OECD Model uses a two way approach of *may be taxed* which gives right to tax dividends to both the States, first where income is generated and second, the State of which recipient is resident.

[1] ***Article 7(1) of OECD Model Tax Convention:*** *The profits of an enterprise of a contracting State shall be taxable only in that State unless the enterprise carries on business in the other contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as are attributable to that permanent establishment.*

[2] ***Article 7(1) of UN Model Tax Convention:*** *The profits of an enterprise of a contracting State shall be taxable only in that State unless the enterprise carries on business in the other contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.*

Article 7 on taxability of business profits states that the profits of an enterprise of a contracting State s*hall be taxable* only in that State, unless the enterprise carries on business in the other contracting State through a permanent establishment situated therein.

The UN Model Convention and commentary thereon concerning dividend income, also provides that dividends may be taxed in the State of the beneficiary's residence. It does not, however, provide that dividends may be taxed exclusively in that State and therefore leaves open the possibility of taxation by the State of which the company paying the dividends is resident, that is, the State in which the dividends originates (source country).

Double taxation is eliminated or reduced through a combination of exemption and tax credit in the residence country and reduced withholding tax rates in the source country.

OECD's preliminary remarks in para 2 and 3 of its commentary on Article 11 (Interest), state that if a recipient of interest income is a resident of other country, he will be liable to be taxed twice on that income—first, by the State of source and, then, by the State of which he is a resident. A formula reserving the exclusive taxation of interest to one State, whether the State of the beneficiary's residence or the State of source could not be sure of receiving general approval. Therefore, a compromise solution was adopted. It provides that interest may be taxed in the State of residence, but leaves to the State of source the right to impose a tax if its laws so provide. Its exercise of this right will however be limited by a ceiling which it cannot exceed.

Article 11 of the UN Model Convention reproduces the provisions of Article 11 of the OECD Model with the exception of paragraphs 2 and 4, in which substantive changes have been made. Even the commentary on paragraph 1 and 2 of Article 11 of the UN Model, reproduces the OECD commentaries on those paragraphs. Accordingly, the understanding of the UN Model on the use of *may be taxed* terminology in Article 11 (Interest) is that of the OECD.

Unlike Articles 7 (Business profits), 10 (Dividends) and 11 (Interest) discussed above, which uses *may be taxed* or *may also be taxed* language, Article 12 (Royalties) of the OECD Model Convention provides that royalties arising in a contracting State and beneficially owned by a resident of the other contracting State ***shall be taxable only*** in that other State.

In its commentary on Article 12, the OECD explains the objective of this language to give exclusive rights to tax royalties only to the State of the beneficial owner's residence. It may however be noted that many OECD member countries including Australia, Czech Republic, Canada, Italy, Japan, Korea, Mexico, New Zealand, Poland, Portugal, the Slovak Republic, Spain and Turkey have recorded reservations about the approval of exclusive residence State taxation. India, as an OECD observer country to OECD, has recorded its disagreements with the text of Model Convention or with an interpretation given in the commentary. On Article 12, India reserves the right to tax royalties and fees for technical services at source.

UN Model on Article 12 (Royalties) substantially differs from the OECD approach. Paragraph 1 of Article 12 of the UN Model provides that royalties arising in a contracting State and paid to a resident of the other contracting State ***may be taxed*** in that other State. Further, the paragraph 2 provides that such royalties may also be taxed in the contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other contracting State, the tax so charged is limited.

As may be seen from the above, it is clear that wherever intention of the OECD is to grant right to tax a particular income to both the contracting States, the language used is *may be taxed* or *may also be taxed*. However, where exclusive rights of taxation are granted to either of the States, the language used is *shall be taxed*; which is further affirmed by the use of the word *only* after *shall be taxed*.

Klaus Vogel

Klaus Vogel, a German expert, points out in his *Double Taxation Conventions* (2007) that Model Conventions use the words *may be taxed in* without using the word *only*. Hence, it refers to the taxation of a particular income in the State of source. However, the issue of taxation of such income in the State of residence remains open. Taxation is left to the State of source, in some cases, the source country has been given the restrictive right of taxation subject to limitation in amount (like Article 10: Dividend and Article 11: Interest).

In that scenario, the effect of double taxation can be mitigated by the State of residence by either exempting the same income in their State or allowing the credit of taxes paid in respect of such income in the source country, depending upon the provisions of the treaty. The phrases *shall be taxable*….. or *may be taxed*….. result in the retention of taxation by a contracting State, whereas the word *only* deprives the other contracting State from its right of taxation over a particular income.

Klaus Vogel's commentary in this regard states that there are two rules of avoidance of double taxation. (1) *Complete distributive rules* apply in case where the word *shall be taxed* ***only***…. is used and it invariably results in exemption. (2) *Open ones rules* (***may*** without ***only***) results in the application of Article 23A or 23B and accordingly either to credit being allowed or exemption being granted.

Apparently, the OECD commentary has construed the words *may be taxed* in a sense that these words do not preclude the country of residence to tax the same income, even if it is taxed in the source country. The tax authorities in India have placed heavy reliance on the abovementioned interpretation of the OECD commentary, to contend that India's right to tax the foreign source income of an Indian resident is not diluted, even if the taxpayer has already been subject to tax in the foreign country.

This view of the Indian tax authorities also draws support from the elimination of double taxation clause of the Indian tax treaties. Their argument rests on the premise that, even if the foreign income is taxed in India, tax treaties provide relief from the double taxation to the taxpayer, either by means of tax credit method or by income elimination method. Whatever be the case, double taxation is avoided and the taxpayer is not at loss.

Departmental Clarification

The CBDT tried to put at rest this controversy by issuing a circular, *Circular No. 91/2008 dated 28th August, 2008*. CBDT clarified that wherever the tax treaties provide that any income of a person resident of India *may be taxed* in the other country, such income shall be first included in his total taxable income and relief from double taxation shall be provided as per the provisions of the concerned DTAA. In other words, the foreign income of Indian resident shall be first subject to tax in India and then relief from double taxation would be granted.

Recently, via the Finance Bill, 2012 the Government has proposed to add Explanation 3 to Section 90 of the Act, to clarify that in case any term used in the DTAA is not defined under the said DTAA or the Act, but is assigned a meaning to it in a notification issued, such meaning shall be deemed to have effect from the date on which the DTAA came into force. Therefore, the terms not defined in the tax treaties and the Act shall be defined by the CBDT. Vide the circular mentioned above, the CBDT has defined the implications of *may be taxed* concept of the tax treaties. However, till the Finance Bill, 2012 is accented to by the President of India, this is only a proposal.

Despite the above circular, taxpayers have claimed that the language *may be taxed* used in tax treaties should be read as *shall be taxed* and the foreign income is not at all includible in the taxable income in India. Even some courts in India have not gone with the interpretation of the tax authorities and the OECD commentary.

Rulings for *May be Taxed* Entails Right to Tax to Only One of Contracting States

- The Supreme Court in *P.V.A.L. Kulandagan Chettiar, 267 ITR 654 (2004)*, though did not interpret the phrase "may be taxed" or analysed the relevance of OECD commentary, held that the right of taxation should be granted to the country with the closer economic relationship to the income.
  In this case, the taxpayer firm owned an immovable property in Malaysia. During the concerned year, it had earned interest income and capital gain from that immovable property. Taxpayers took a view that the income arising in Malaysia cannot be taxed in India as it had no permanent establishment in India. Tribunal confirmed the order of the CIT (A) stating that the property is situated in Malaysia, hence, capital gain arising on sale of such property cannot be brought to tax in India. The Supreme

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Court held that the fiscal jurisdiction of a State in respect of taxation of a particular income can be determined either by reason of residence of the taxpayer or by reason of source of income. Article IV of the India-Malaysia DTAA implies that tax liability that arises in respect of a person residing in both the contracting States, has to be determined with reference to his close personal and economic relations with one or the other State. Capital gain arising from the immovable property cannot be brought to tax in India because of closer economic relations between the taxpayer and Malaysia in which the property is located, i.e. State of source. In the absence of permanent establishment in India, there is no nexus between the incomes derived with the State of residence. Consequently, even the business income out of the rubber plantations cannot be taxed in India.

- In *Turqouise Investment & Finance Limited, 2008-TIOL-31-SC-IT (2008)*, the Supreme Court addressed an issue of taxability of dividend income earned from a company in Malaysia and held that dividend income derived by the taxpayer from a company in Malaysia is not liable to be taxed in the hands of the taxpayer in India under any of the provisions of the Income-tax Act of India.
- In the case *R. M. Muthaiah, 202 ITR 508 (1992)*, the Karnataka High Court while dealing with the question of taxability of income from immovable property in Malaysia granted the right to tax the income to the source country i.e. Malaysia to the exclusion of India. Regarding the Article on elimination of double taxation of the India-Malaysia DTAA, the Court opined that Article 22 is attracted only when tax is levied by both countries. In a case where one of the countries is precluded from levying a tax on the income in view of the specific provision in the treaty, the said clause cannot be attracted at all.
- On the same aspect, the Mumbai Tribunal in the case *Pooja Bhatt vs. Dy Commissioner of Income Tax [ITA No. 7000/Mum/2005] (2008)* (unreported), addressed the issue of taxation of foreign income of an Indian resident artist earned from entertainment shows in Canada. Tax authorities rejected the contention of the taxpayer of being taxed in Canada and held that being resident of India, her global income including income earned from performance in Canada is liable to get taxed in India. Order of the tax authorities was upheld by CIT(A).

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Aggrieved taxpayer preferred an appeal before the Tribunal. The Tribunal concluded that income derived by the taxpayer from exercise of her activities in Canada is taxable in the source country only, i.e. Canada. To arrive at its conclusion, the Tribunal looked into the scheme of taxation of income contained in Chapter III of the India-Canada DTAA. On an analysis of various Articles contained in Chapter III of the India-Canada DTAA, the Tribunal observed that the scheme of taxation in the treaty is divided in three categories, viz.

1) income taxable only in the State of residence;
2) income taxable only in the source country; and
3) income may be taxed in both the contracting States.

Tribunal concluded that wherever the contracting parties intended to give the taxing right of a particular income to both the countries, they have specifically provided the same in clear terms. Consequently, it cannot be said that the expression *may be taxed* used by the contracting parties gives option to the other contracting State to tax such income. The expression *may be taxed in the other state* permits only the other State, i.e. the State of source, and State of residence is precluded from taxing such income. The Tribunal while rejecting the OECD commentary mentioned that the commentaries are not binding on the Indian courts, since the same are of persuasive value or indicative of contemporaneous thinking. The parties to the agreement, i.e. the Governments of the two States, are always at liberty to deviate from the same.

- In a recent ruling of *Essar Oil Limited, ITA No. 2441/MUM/2007 (2011)*, the Mumbai Tribunal held that the expression *may also be taxed* used in Article 7 of the India-Qatar DTAA, permits only the State of source to tax such income and the State of residence is precluded from taxing such income.

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While there are a number of court rulings favouring that *may be taxed* language gives unequivocal rights to one of the contracting States, there are very few rulings against this interpretation:

- The Authority for Advance Rulings (AAR) in the case *S. Mohan 267 ITR 654 (2007)* held that salary income of an Indian resident was liable to taxation in both the countries, i.e. India and Norway, and India should give a credit for the taxes paid by the taxpayer in the other country. In this case, the AAR ruled out that the word *may be taxed* used in the Article 16 (Salary) of the India-Norway DTAA provides the right of taxing the salary income to both the jurisdictions.
- Recently, the Delhi Tribunal in the case *Telecommunications Consultants India Ltd. ITA No. 135 of 2008 (2012)* addressed the issue of taxation of foreign income earned by a public sector undertaking engaged in the business of providing consultancy, design and engineering services in all the fields of telecommunication in India as well as abroad. The taxpayer claimed that the profits of an enterprise of the contracting State shall be taxable only in the State, unless the enterprise carries on business in the other contracting State through a permanent establishment situated therein. Therefore, once the revenue accepts that there is permanent establishment outside India, the same shall be taxable only in the country of source according to Article 7 and residence would not be a determinative criteria. The taxpayer relied on all the cases cited above.

  In this aspect, the Delhi Tribunal differentiated the facts of above stated ruling with the facts of present case and held the same to be liable to tax in India. Further, the Delhi Tribunal laid down:

  1. The distributive rules on use the words, *shall be taxable only*, *may be taxed* and *may also be taxed*. The words *shall be taxable only* in a contracting State preclude the other contracting State from taxing, thus double taxation is avoided. Whereas, the phrase *may be taxed* does not give the exclusive right to tax to any contracting State. In such a case, the State of residence must give relief, so as to avoid the double taxation.
  2. Apropos the above, it was held that the words *may be taxed* provides that the source country would have the right to tax business income to the extent the same is attributable to the permanent establishment in another state. However, providing such right to tax does not exclude the resident State from taxing such income based on its domestic tax laws and under the DTAA.

The Mumbai Tribunal in the case of *Pooja Bhatt* addressed the issue of taxation of foreign income of an Indian resident artist earned from entertainment **shows in Canada. Tax authorities rejected the contention of the taxpayer of being taxed in Canada and held that being resident of India, her global income including income earned from performance in Canada is liable to get taxed in India.**

In arriving at the above conclusion, the Delhi Tribunal has distinguished the various cases relied upon by the taxpayer. The Tribunal held that the mother of all case laws, being relied upon by the taxpayer is the Supreme Court decision of *PVAL Kulandagan Chettiar (supra)*. All subsequent case laws have followed this decision. It is therefore important to examine what the Court has held in the case of *PVAL Kulandagan Chettiar*. The facts of taxpayer's case are completely different set of facts than the decision of PVAL Kulandagan Chettiar. In that case, the taxpayer sought a relief under the DTAA between India and Malaysia. The Supreme Court held that it was a case of dual residency. The Supreme Court's conclusion rests on the fact that personal and economic relations of the taxpayer in relation to capital asset were far closer in Malaysia than in India and in these facts, the residence of India became irrelevant. The taxpayer was not having permanent establishment in India in respect of that source of income. On the aspect and scope of the expression *may be taxed*, the Apex court did not express any opinion. Therefore, the incomes derived from rubber plantations of Malaysia were held to be not assessable in India. Similarly, the capital gain arising on the sale of immovable property in Malaysia was held to be not assessable income in India and business income for not having permanent establishment in India.

Conclusion

So, we are confronted with two schools of thoughts regarding the interpretation of language *may be taxed*

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used in the tax treaties. One view is that, unless there is a specific mention in the tax treaties that both the countries have right to tax a particular income, only one of the countries should have jurisdiction to levy tax, with the exclusion of the other. The other view is that both countries can levy tax on the same income. However, in such a case, double taxation would be avoided by the State of residence, by allowing tax relief as per the provisions of the relevant tax treaty.

As noted above, even the courts' views are divided on this issue.

The Courts following a favourable view on this issued have unequivocally relied on the Supreme Court's ruling of *PVAL Kulandgam Chettiar (supra)*. The Apex court in the *PVAL Kulandgam Chettiar*, though not directly, dealt with the interpretation of may be taxed language used in the India-Malaysia tax treaty, however, gave some principles in the direction. The recent ruling of the Mumbai Tribunal in the case of *Telecommunication Consultants India Ltd. (supra)* has very clearly interpreted and explained the ratio arising from the *PVAL Kulandgam Chettiar* ruling, which was probably not done by any court before. The Mumbai Tribunal has given an interpretation that *may be* tax does not preclude the residence country from taxing the income generated by its resident from another country. Such an interpretation is close to international approach and confirms to the 2008 circular issued by the CBDT. Since the circulars issued by CBDT are binding on tax authorities, they are bound to follow this. Once the Finance Bill, 2012 becomes applicable, such interpretation given by the CBDT will become the law of the land. Such an interpretation carries more weight and seems to be a better approach. Further, the taxpayer will not lose anything as he will get credit of taxes, if any, paid in the source country. ■